LIQUIDITY INDEX

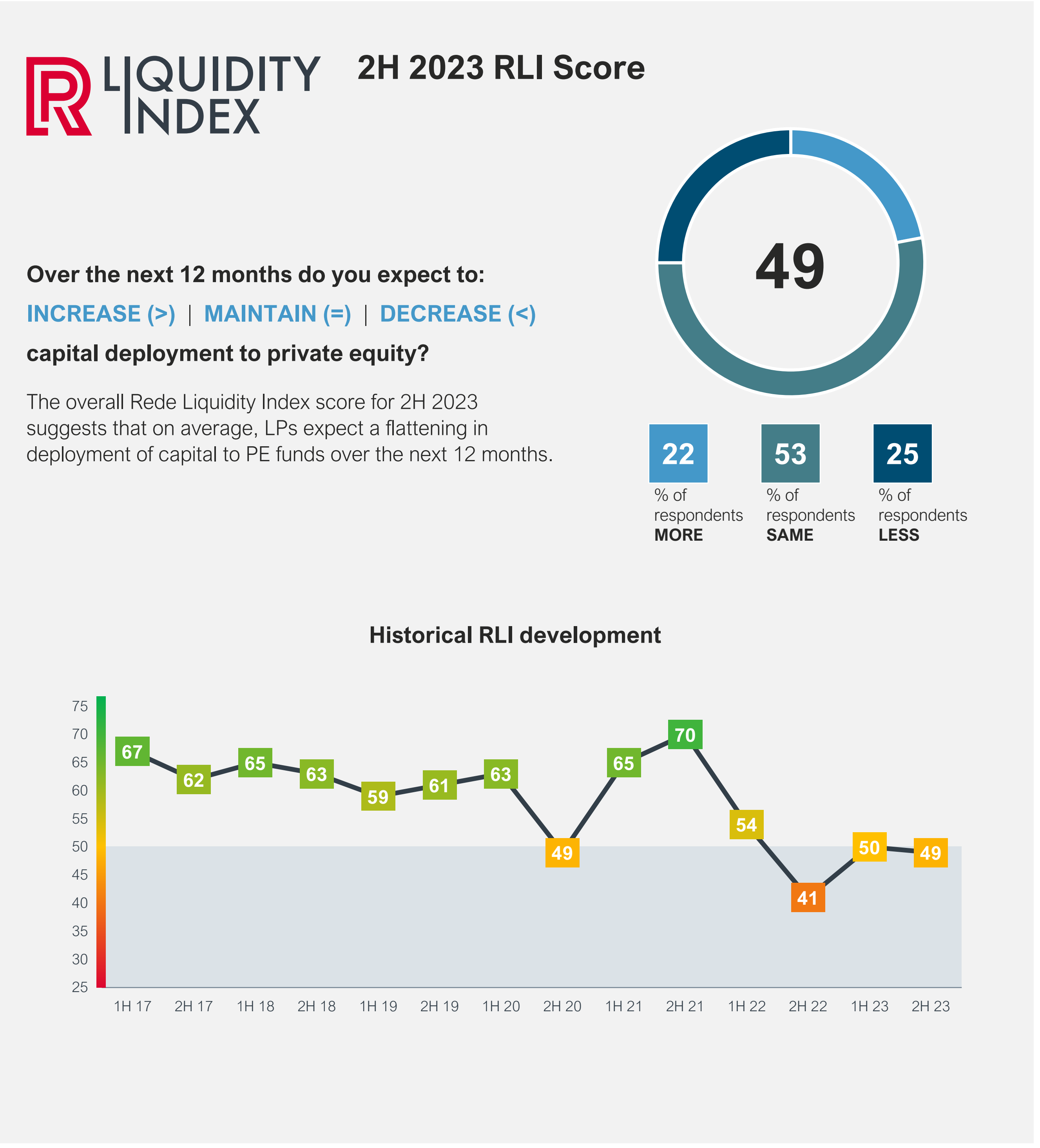
2H 2023

February 2024

rede-partners.com

Introduction

The Rede Liquidity Index score for 2H 2023 is 49, meaning that on average, LPs expect a very small decrease in their deployment of capital to PE funds over the next 12 months. The RLI score fell by 1 point from 50 in 1H 2023, dampening hopes of a substantial bounceback in fundraising momentum.



Key findings

1

Recovery plateaus as LP sentiment remains flat

The RLI score for 2H 2023 fell by a single point to 49, indicating LPs on average expect to allocate very slightly less capital to PE funds. This indicates LP sentiment remains muted, but that the sharp drop in LP liquidity seen over recent quarters appears to have plateaued.

2

LPs look for liquidity as pessimism prevails over exits

Sentiment towards distribution flows has risen 13 points but LPs remain pessimistic with an RLI score for distributions of 31. 61% of LPs report the slow pace of distributions to be the key concern as they plan 2024 agendas, with knock-on effects for their own liquidity – 42% are concerned about securing capital for their own investment programmes.

3

Re-ups tougher to secure but investors are increasingly open to new relationships

The RLI for new money commitments has increased by 6 points to 52, but the score for existing GP relationships dropped to 45, indicating that LPs' commitments to new relationships will come at the expense of their existing GPs. LPs on average expect to earmark 59% of their 2024 allocation to re-ups, down from 70% this time last year.

4

Market conditions boost the appeal of private credit and Smaller Buyouts; North American-focused GPs remain most in demand

Despite a challenging overall picture for fundraising, there remain pockets of the market for which LPs continue to show robust demand. 50% of LPs plan to increase exposure to lower midmarket buyouts over the next year, with additional strong appetite to expand commitments to midmarket buyouts (46%), healthcare (35%), private credit (31%) and Sustainability / Impact (28%). North American focused GPs are in demand scoring 57 points, with investors in all geographies expressing strong appetite to deploy capital into North American-focused funds.

Introduction

Introduction

Welcome to the 12th edition of the Rede Liquidity Index (RLI), looking at institutional investor sentiment towards Private Equity ("PE") in the second half of 2023.

The latest data shows us that sentiment has slipped by a single point for an overall RLI score of 49 in the second half of the year. The increased RLI score for the first half of 2023 (+9 points to 50) indicated that the downward trajectory for Private Equity fundraising had flattened. The latest RLI results suggest that this plateauing is continuing.

Over the last year, there have been several factors which may have contributed to the challenging fundraising market including public market valuations, energy prices, the turbulent macroeconomic environment and geopolitical tension. Although, tragically, global conflicts continue to escalate, public markets are back to record highs and inflation is increasingly under control. Our research highlights that LPs are now most concerned about the diminished flow of distributions, which is impacting their own liquidity and ability to deploy to new funds.

Re-ups, which often set the pace for first closes, are increasingly tougher to secure. LPs are indicating they expect to decrease commitments to funds managed by GPs with whom they have existing relationships. On the other hand, LPs are increasingly open to building new relationships, creating opportunity for newer GPs to seize market share and opening the door for fundraising success to a select few first time funds.

When it comes to fundraising, LPs are very much in the driving seat and refuse to be rushed, taking their time in diligence and manager selection. In the search for fundraising momentum, GPs are considering what they can offer in terms of sweeteners. Beyond the discounting mentioned in the 1H 2023 report, we are now also a number of other trends in this area. In particular we are seeing GPs offering increasingly high co-investment ratios to LPs, and we also note that the 'aged primary' is very much back in vogue. As fundraising takes longer, LPs are able to watch and wait to see assets in the funds in which they invest, often creating significant arbitrage on the effective entry price that final close LPs are paying.

The ongoing challenging market picture means that LPs are ever more selective – but there are still areas that clearly buck these trends. Our research highlights some pockets of the market where we see robust appetite from LPs. There is a continued preference, globally, for North American-focused managers, with European-focused managers a close second. Demand remains strong and is increasing for smaller-sized buyouts in the lower-midmarket and midmarket. Credit and Sustainability-oriented strategies (particularly those relating to climate or decarbonisation) are also experiencing increased LP appetite. Meanwhile, healthcare has now overtaken technology as the sector most in demand by LPs.

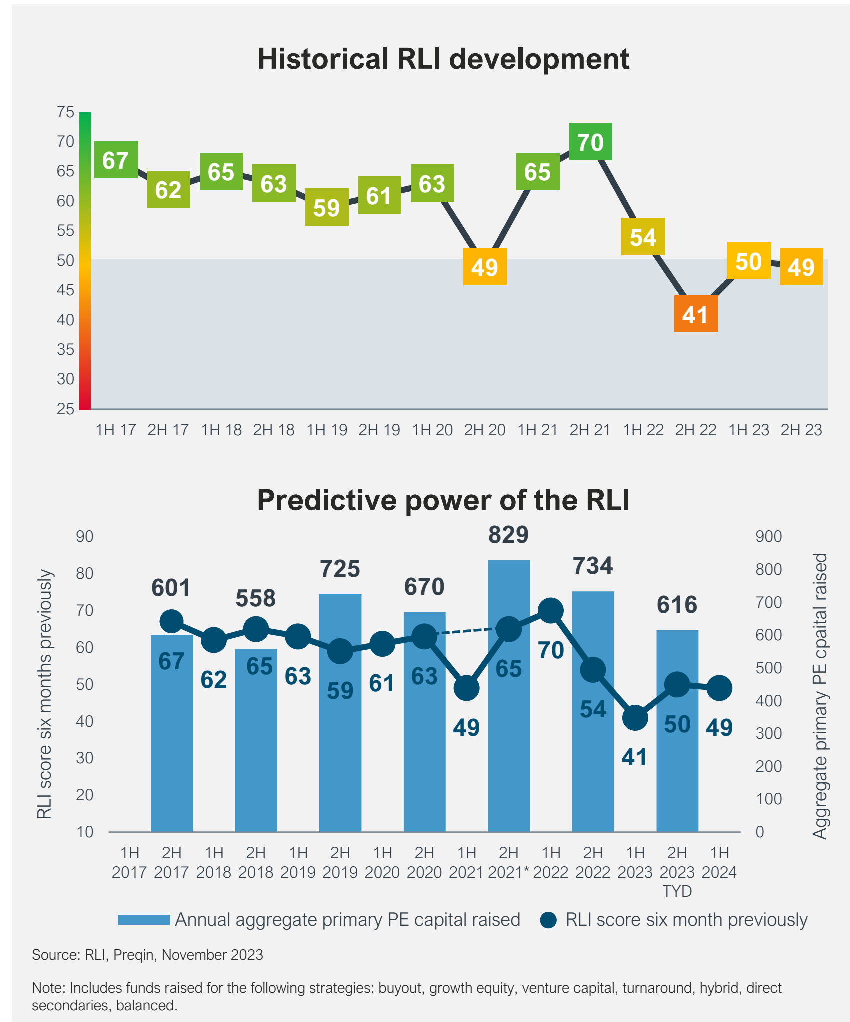
What the numbers mean

The RLI is a twice-yearly measure of liquidity across the PE Limited Partner universe, comprising a composite index with several sub-indicators. It is based on liquidity projections for the year ahead, with participating LPs asked if they were expecting to deploy more, the same or less to PE during the upcoming 12 months compared to the previous 12 months. If 100% of respondents reported an increase, the index would be 100. If 100% reported a decrease, the index would be zero. If 100% saw no change, the index would be 50. So, an index score of over 50 would indicate an improvement and, therefore, positive sentiment.

1 Recovery plateaus as LP sentiment remains flat

The RLI score for 2H 2023 dropped by one point to 49, indicating that LPs on average expect to allocate very slightly less capital to Private Equity funds. This dampens hopes that fundraising will continue to substantially rebound in 2024 despite climbing to 50 in 1H 2023 from a record low RLI score of 41 in 2H 2022.

The RLI is a forward-looking indicator, measuring LP expectations for their future deployment. In the first half of 2022, we observed a key inflection point in the RLI, as it began a vertiginous drop from the high water mark of 70 it had reached at the end of 2021. By the second half of 2022, the RLI had slumped to a record low of 41, fueled by geopolitical turbulence, a range of macroeconomic challenges and increasingly difficult trading conditions for GPs. Over the months that followed, we saw the consequences of this fall in LP confidence play out in real-time.



Source: RLI, Preqin, November 2023

Note: Includes funds raised for the following strategies: buyout, growth equity, venture capital, turnaround, hybrid, direct secondaries, balanced.

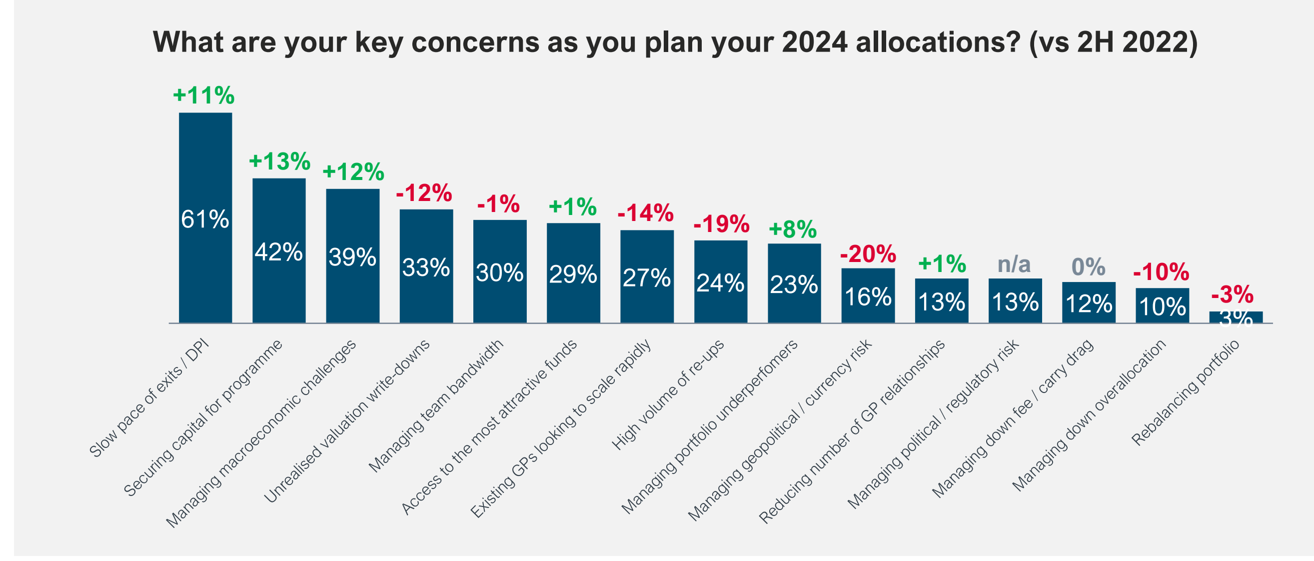
* For 1H 2021 the RLI score six months previously is an outlier, due to the rapidly changing COVID outlook at the time the RLI data was being collected during the second half of 2020. LP sentiment suffered a sharp but brief dip during the period that the majority of data was collected, due to persistent COVID prevalence and a lack of progress in vaccination development programmes. This reversed rapidly in the later months of 2020.

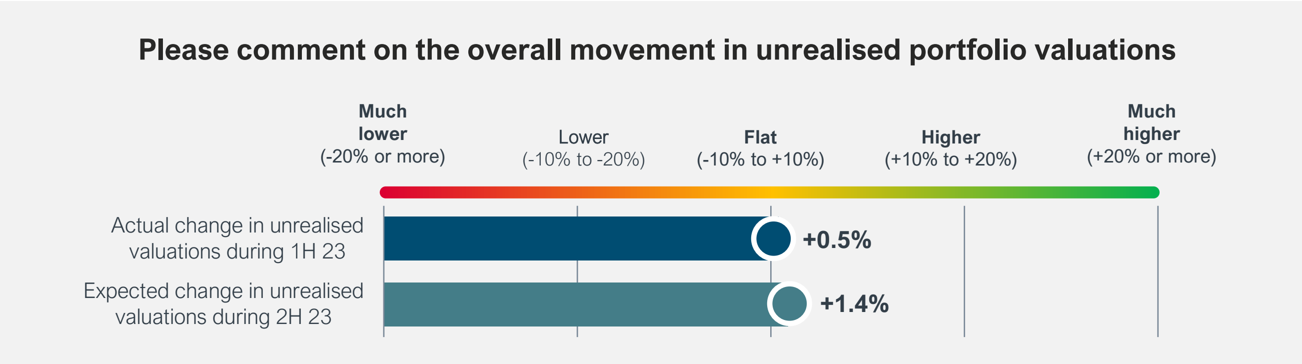
Aggregate fundraising commitments fell across the board, reversing a longer-term trend toward expansion within the asset class.

Amidst this market contraction, the most pressing question then became: when will fundraising conditions improve? Again, the forward-looking nature of the RLI makes it a helpful tool as we seek to answer that question.

Rede has been publishing RLI data twice yearly since 2018. Inflection points where the RLI 'changes direction' typically herald a matching shift in the overall fundraising market the next year. By offsetting the RLI score by six months, and then overlaying this with actual annual fundraising data, we can see a correlation starting to emerge, showing the predictive power of the RLI. The exception to this rule is the short, sharp dip in LP sentiment that the RLI identified in the second half of 2020 during the pandemic which did not, in fact, result in a dip in fundraising momentum in 2021. This can be explained by the emergence of COVID vaccination programmes in early 2021, leading to the pandemic coming under control earlier than could have reasonably been expected during the summer of 2020, when the majority of the 2H 2020 RLI data was collected.

Looking at the RLI scores for 1H and 2H 2023, it is clear that LPs are still feeling the squeeze and are not expecting a major change in market dynamics any time soon. The RLI score of 49 suggests that over 2024 we should expect to see fundraising momentum remaining relatively flat, with no major recovery but equally no further tightening in conditions.





Delving deeper into the RLI data allows us to examine the reasons behind LPs' continued muted expectations. In our experience, there are four key drivers of overall fundraising momentum: overall sentiment toward the asset class, its recent absolute and relative performance, LPs' top-down allocations and recent flows of capital distributed back to investors. Our research highlights some of these areas where challenges remain – and it would be reasonable not to expect a major bounceback until each of these has been substantially 'solved'.

While LPs maintain a positive disposition toward private markets as a value-accretive investment strategy, their portfolios have remained mostly flat in valuation over the past year – overall LPs expected only a 1.4% increase in their unrealised portfolio valuations over 2H 2023. The continued macroeconomic uncertainty, geopolitical unrest and high-interest rate environment mean that investors are expecting ongoing difficulties extending into 2024. We saw a 12% uptick in LPs indicating that managing macro challenges will be a key concern for them next year.

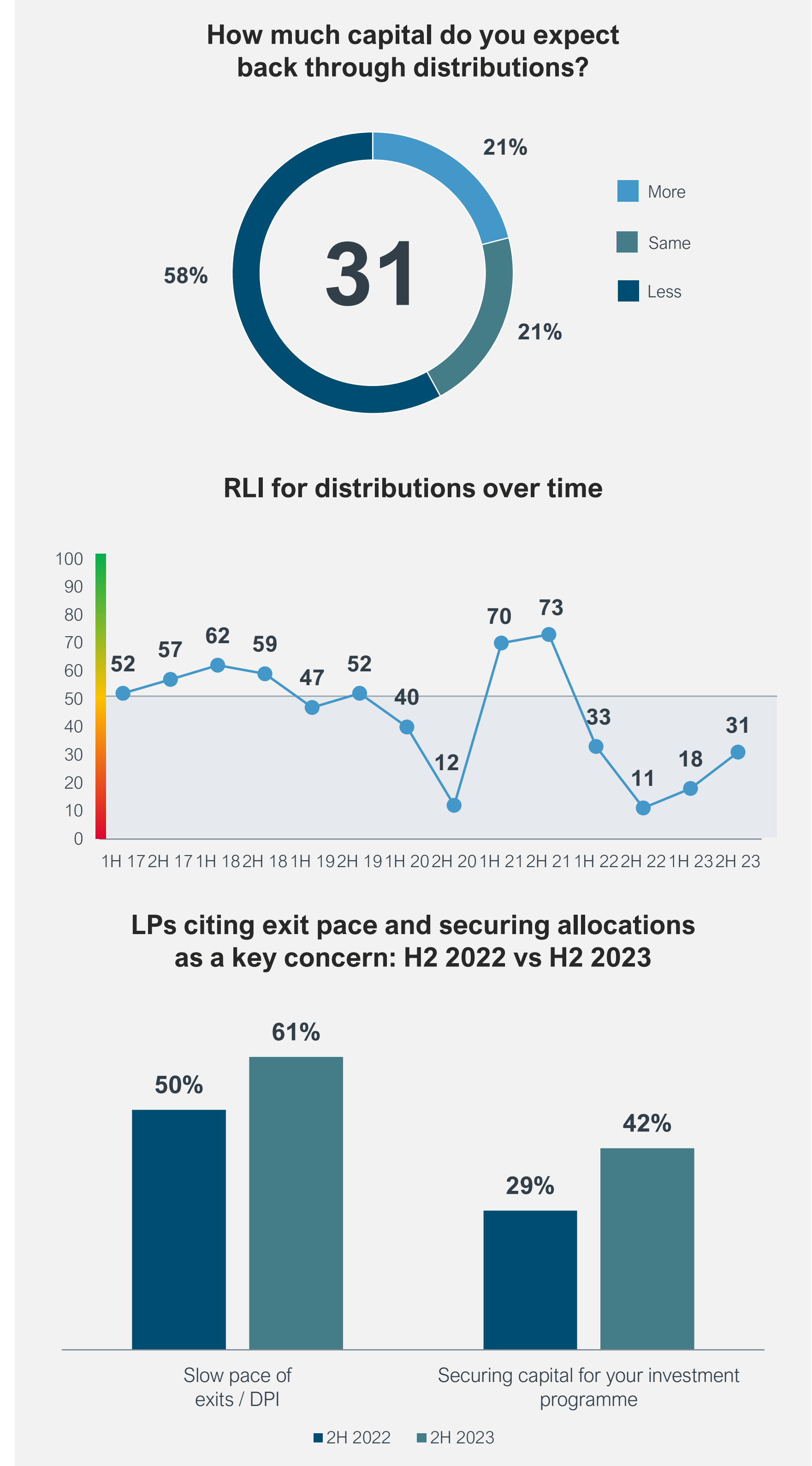
Meanwhile, LP allocations continue to experience some squeezing from the top, with 30% of investors reporting their programmes to be sitting at the upper end or above their target allocations, while 42% of LPs (an increase of 13% since this time last year) cited securing sufficient allocation for their programmes to be a key worry as they enter 2024. Finally, as we will explore in the next section, LPs' concern about the slowed pace of distributions has reached a crescendo – 61% of investors cite this as a major issue.

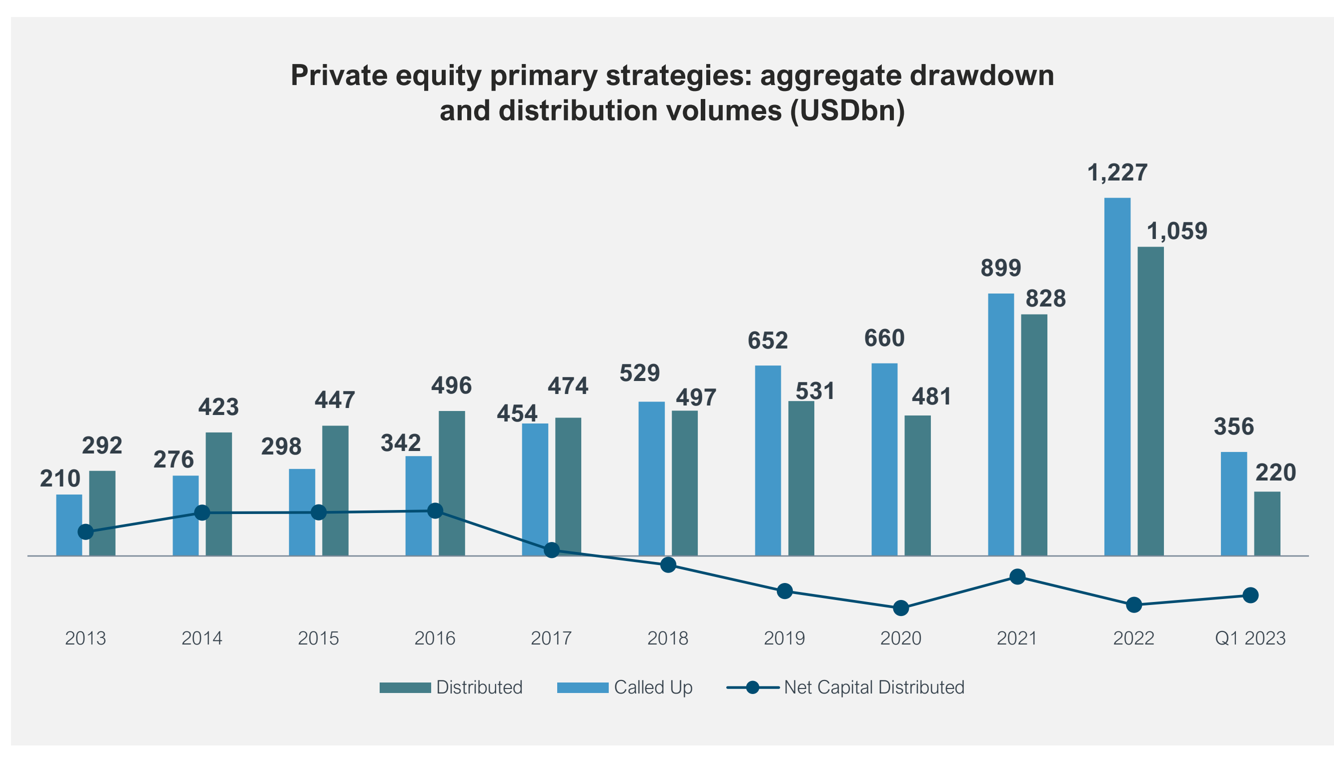
2 LPs look for liquidity as pessimism prevails over exits

Sentiment towards distribution flows has risen 13 points but remains pessimistic with an RLI score for distributions of 31. 61% of LPs report slow pace of distributions to be a key concern as they plan 2024 agendas, with knock-on effects for their own liquidity – 42% are concerned about securing capital for their own investment programmes,

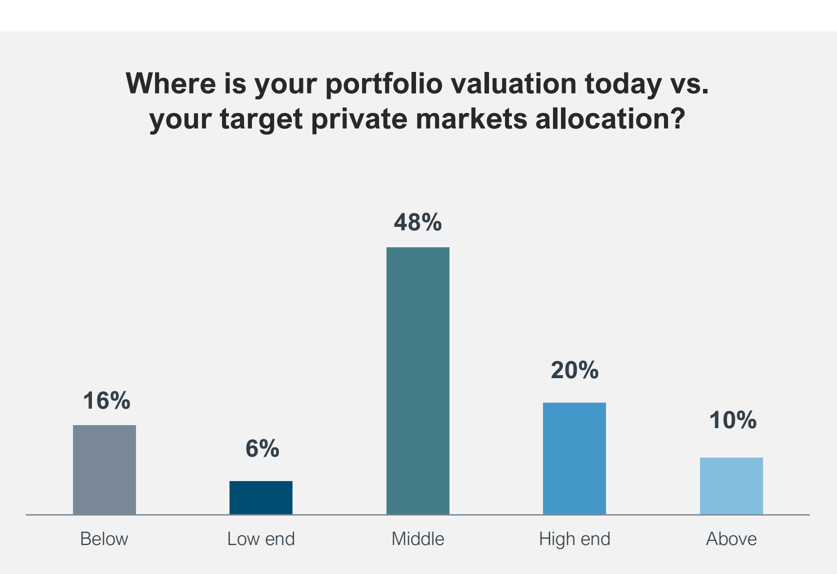
A slowdown in exits and distributions has materially impacted liquidity and overall LP confidence. 59% of LPs surveyed expected less capital back through distributions. 61% of LPs cited "Slow pace of exits and DPI" as a primary concern as they consider 2024 allocation plans, an increase of 11 percentage points over 2H 2022.

It is important to note, however, that overall exit volumes remain high when compared with figures seen just a few years ago. The total volume of distributions in the first quarter of 2023, for example, was similar to that of the whole year a decade previously. The issue at hand, therefore, is not specifically a low absolute level of exits but more an inbalance between capital called up and distributions. Since 2019, LPs have on average been asked to send more capital to their managers than they have been sent back, which creates a very real squeeze on their ability to commit to new funds. The trend in net capital flow appears to be slowly moving in a more positive direction, but is seems unlikely that it will be reversed until at least early 2025 – creating an ongoing drag on fundraising momentum.





GPs are increasingly aware of the imperative to deliver DPI at scale and pace to their investors. They are becoming more front-footed in exploring liquidity solutions including partial exits, continuation vehicles, minority or 'strip' sales and NAV financings. While these are not substitutes for 'real' exits, they are important elements of the modern fund manager's arsenal, allowing managers to maintain ownership in assets to maximise eventual value while offering existing LPs interim liquidity on attractive terms.



Meanwhile, as noted in the previous section, the distribution squeeze appears to be an important factor in a new and potentially worrying trend emerging from the RLI data: that of LPs worried about their ability to secure capital for their investment programme. Over the last year, the number of LPs citing this as a key concern has jumped from 29% to 42%, while 30% of LPs reported their investment programme being at the high end or above their allocation target. We are also seeing a 'second order' liquidity effect coming through in investors such as funds-of-funds, who must themselves fundraise in order to deploy. With fundraising momentum having stalled in mid-2022, these funds-of-funds now have less capital available to deploy to primary funds.

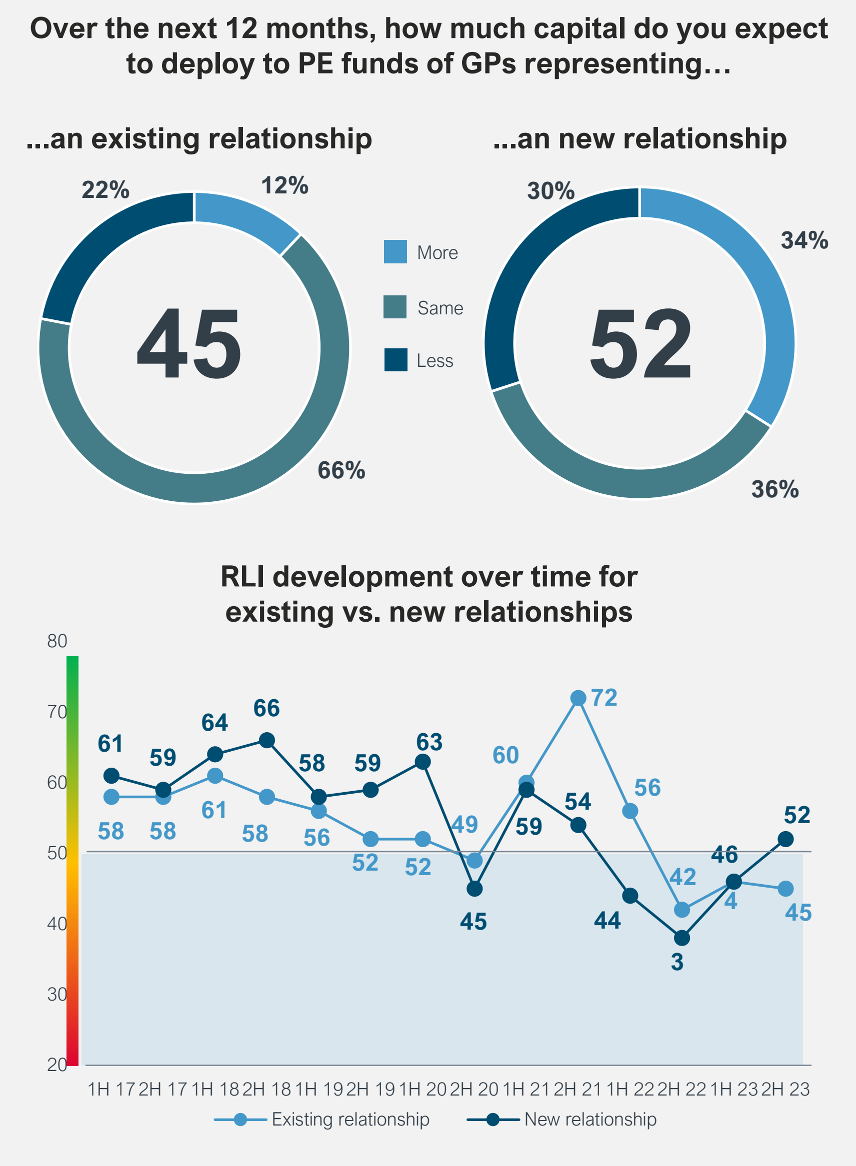
3 Re-ups tougher to secure, but LPs increasingly open to new relationships

The RLI for new money commitments has increased by 6 points to 52, but the score for existing GP relationships dropped to 45, indicating that LPs' commitments to new relationships will come at the expense of their existing GPs. LPs on average expect to earmark 59% of their 2024 allocation to re-ups, down from 70% this time last year.

Over the last year, the RLI has shown a reversal in LPs' relative sentiment between existing and new GPs' fundraising opportunities. LPs now expect to commit more capital to funds managed by GPs with whom they do not already have a relationship than to those of their existing managers.

Taking a longer term view, we can see that in fact, this should be seen as a return to the status quo. Over our 14 editions of the Rede Liquidity Index, the RLI score for new relationships has been higher than that the score for existing relationships in nine of them. The exception to this rule is the period from 2H 2020 to 2H 2022. Building new relationships was highly challenging during the pandemic, with travel restrictions and real difficulties in getting to know potential investee managers in a face-to-face setting. LPs therefore defaulted to reupping with existing relationships, with whom they already had built a personal connection before the pandemic began.

Once the restrictions began to ease, we might have expected a rapid reversal in this trend. However, the tail end of the pandemic coincided with an unprecedented period of



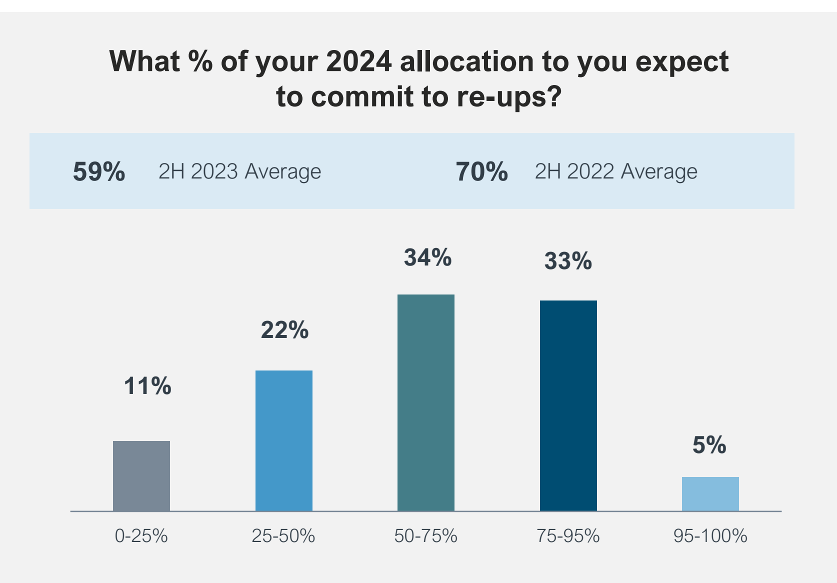
outstanding performance across the asset class. LPs' portfolios were mostly performing to a very high standard, reducing the imperative to spend time and energy identifying exciting new managers.

The shift in market dynamics in 2022 was the eventual catalyst for this overdue change in LP behaviour. By early 2023 LPs were increasingly seeing pockets of underperformance within their portfolios, and with travel and face-to-face interaction now firmly back on the agenda, they began to actively seek to rotate out existing GPs for new relationships. We expect this trend to continue throughout 2024 and potentially beyond.

LPs on average expect to earmark 59% of their 2024 allocation to re-ups, down from 70% this time last year, meaning a greater proportion of their allocation will be freed up to commit to new relationships. This is good news for emerging managers and first time funds, who by definition rely on forging new LP relationships in order to achieve fundraising success.

On the flipside, fewer and smaller re-ups can significantly reduce the momentum of a fundraise. Achieving a substantive first close supported by 'cheerleader' existing LPs acts as a strong catalyst for newer LPs who have been circling. First closes that represent a high percentage of the fundraise target create scarcity and motivate investors to increase the pace of their process.

As re-ups become harder to secure, some GPs find themselves on the back foot, considering what sweeteners they can offer to ensure a first close gets across the line. These typically take the form of first close and size discounts as well as increased co-invest offerings. In Rede's anecdotal experience, around a third of private equity fundraisings launched over the past 18 months have fee discounts (for private credit this is significantly higher at around 75%). We are also seeing GPs offering increasingly high co-investment ratios to LPs, which creates a 'synthetic discount' for LPs on a blended basis. We also note a much greater prevalence of 'aged primary' offerings. As fundraising takes longer, LPs are able to watch and wait to see assets in the funds in which they invest, often creating significant arbitrage on the effective entry price that final close LPs are paying.



4 Market conditions boost appeal of private credit, Smaller Buyouts and Impact strategies; while North American-focused GPs are still most in demand

Despite a challenging overall picture for fundraising, there remain pockets of the market for which LPs continue to show robust demand. 50% of LPs plan to increase exposure to lower midmarket buyouts over the next year, with additional strong appetite to expand commitments to midmarket buyouts (46%), healthcare (35%), private credit (31%) and Sustainability / Impact (28%),

Although overall sentiment has fallen, our data highlights a number of areas where investor interest is growing. There is a rebalancing from growth-oriented investing to value-oriented investing and within asset classes a tilt towards income yielding, downside protected asset classes like credit, versus pure equity.

Appetite for smaller buyouts has continued to grow with around half of LPs surveyed expressing an intention to increase their exposure to the lower mid-market and a further 46% plan to add more capital to mid-market buyout funds in the next 12 months. These sectors are seen to offer attractive valuations in periods of macroeconomic volatility. They tend to be less reliant on leverage and financial engineering in the model and control positions offer more opportunity to exert influence over value creation initiatives.

31% of LPs surveyed indicated their intention to increase allocation to private credit. private credit is particularly attractive in times of volatility given its structural protections against inflation and downside, as well as contractual return profiles and low reliance on economic growth. LPs are becoming more sophisticated in their approach to private credit, with many more specialist investment professionals being hired within dedicated credit teams. This has led to a growing sophistication in LP portfolio construction within credit, and in particular, increased appetite for a broader spectrum of credit strategies and returns profiles. Traditional direct lending funds are increasingly being supplemented by a range of strategies offering low double-digit IRR and a burgeoning interest is emerging in opportunities outside straightforward fund commitments including credit secondaries and co-investment.

Appetite for healthcare strategies has now overtaken Technology with 35% of LPs expressing an intention to expand their commitments in the sector. Healthcare benefits from relative insulation from market cycles, steady cashflow and revenue streams, while retaining strong upside potential through technology-led and scientific innovations. There are far fewer dedicated healthcare-focused GPs than GPs focused on other sectors. This relative scarcity and the defensive characterisitics mean that we would expect high quality healthcare-focused GPs to achieve strong fundraising results in 2024.

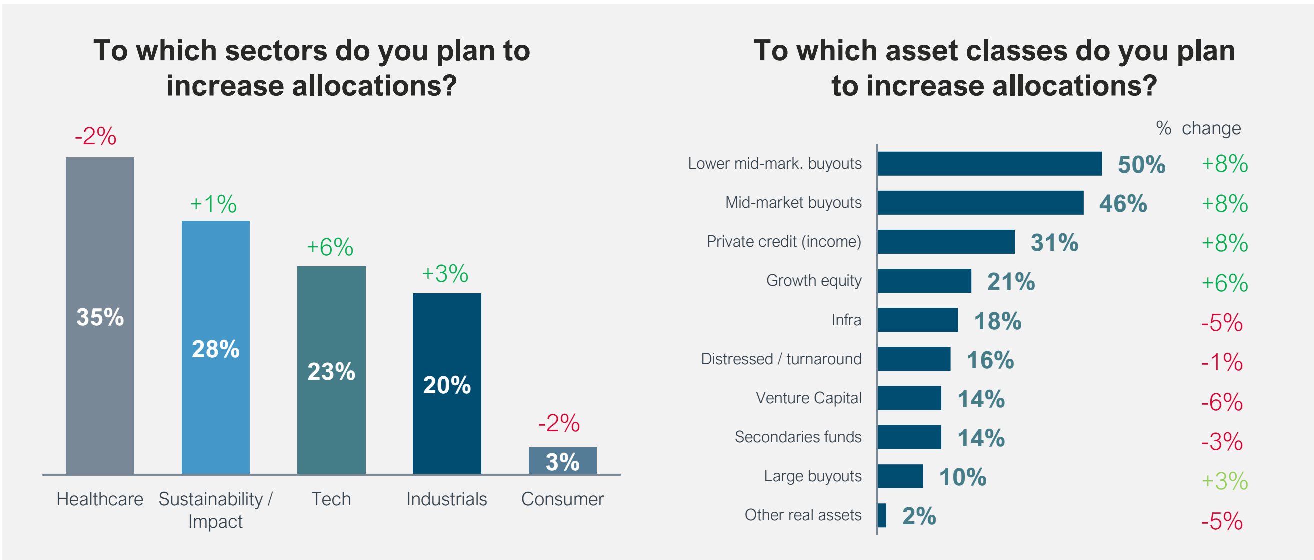
Impact and Sustainability-focused funds are another pocket where LP interest remains robust with 28% of LPs reporting they are looking to increase their exposure. There is widespread, if not universal, recognition that Sustainability megatrends provide not only a compelling need but a compelling opportunity for investment. This has been reinforced by strong performance from specialist Impact managers posting top tier returns and highly credible GPs entering the market.

LP deployment to Impact is more developed in Europe than in North America. However, we expect that American LPs will likely start to catch up with their European peers in allocating specifically 'decarbonisation'-related investment funds. This segment of the Impact / Sustainability asset class is now reaching 'breakout' status, with rapid acceleration in both GP landscape development and LP enthusiasm. The decarbonisation theme stretches well beyond power generation and incorporates a wide range of strategies seeking to reduce the carbon load of the global economy including, industrials, logistics, transport, real estate and consumer products and services. It is clear that generalist LP teams are now increasingly eager to invest in these funds which they see as potentially highly lucrative. On the other hand, the success of decarbonisation appears to be coming at the cost of funds with more generalist Impact strategies and Social Impact-focused funds, who remain reliant on dedicated pockets of capital.

North American-focused GPs continue to see healthy LP demand with the in-bound RLI for North America standing at 57 points. Investors in all geographies expressed strong appetite to deploy capital into North American-focused funds. LPs also indicate an overall intension to expand deployment to funds focused on Europe, with an RLI score of 53. Conversely, they plan to reduce their commitments to funds focusing on Asia (RLI score of 27) and the Rest of the World (RLI score of 31).

The strong in-bound RLI score for North America could be seen LPs fleeing to what they see as the world's most mature and diversified PE market. The US is also seen as being somewhat insulated from the direct impact of geopolitical tensions and acute inflationary pressures – although we may see this theory tested in the spotlight of the US Presidential Elections of 2024. It should also be noted that the outbound RLI score for North America (i.e. the liquidity picture for LPs headquartered in North America) does reveal some ongoing malaise, with a fatigued score of 44 indicating an expectation that North American LPs will slow their investment pace over coming months.

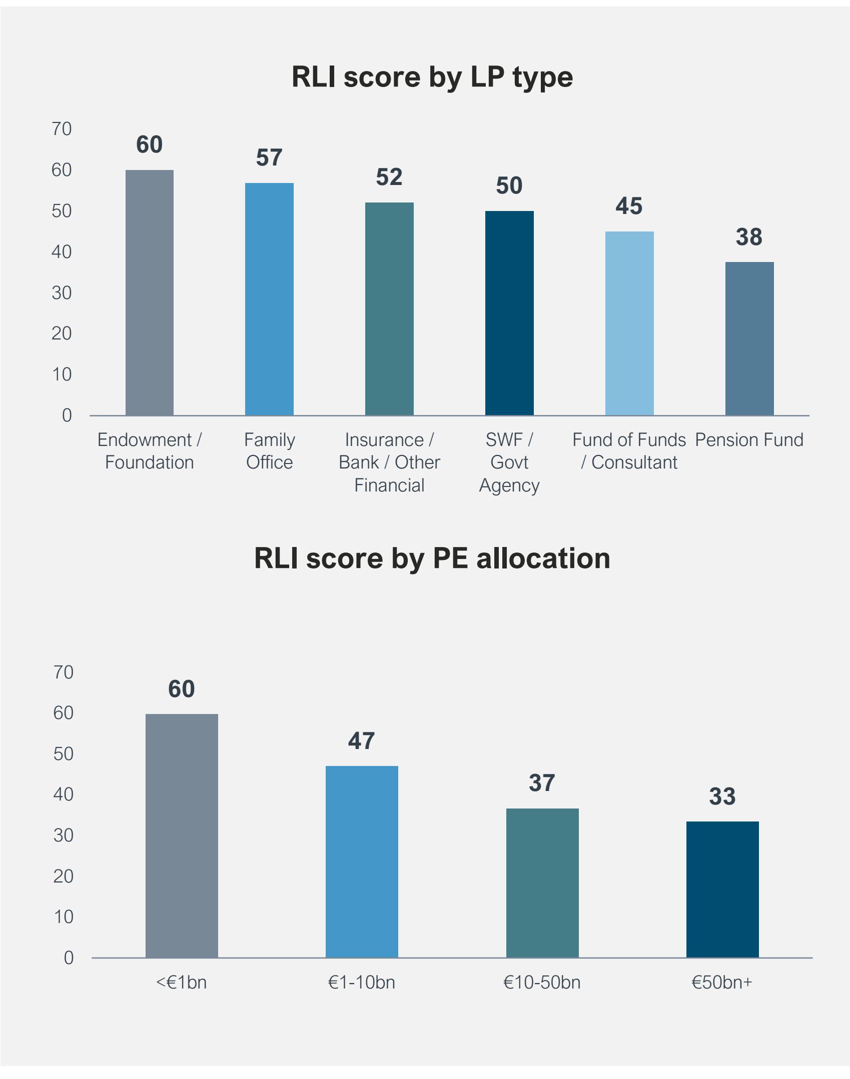
We see a greater divergence in Europe, where global expectations for allocating capital into the region remain relatively positive (53) but for LPs in the Eurozone specifically the oubound RLI score has fallen by nine points over the last six months to 48.



Further RLI analysis

RLI by investor type and size

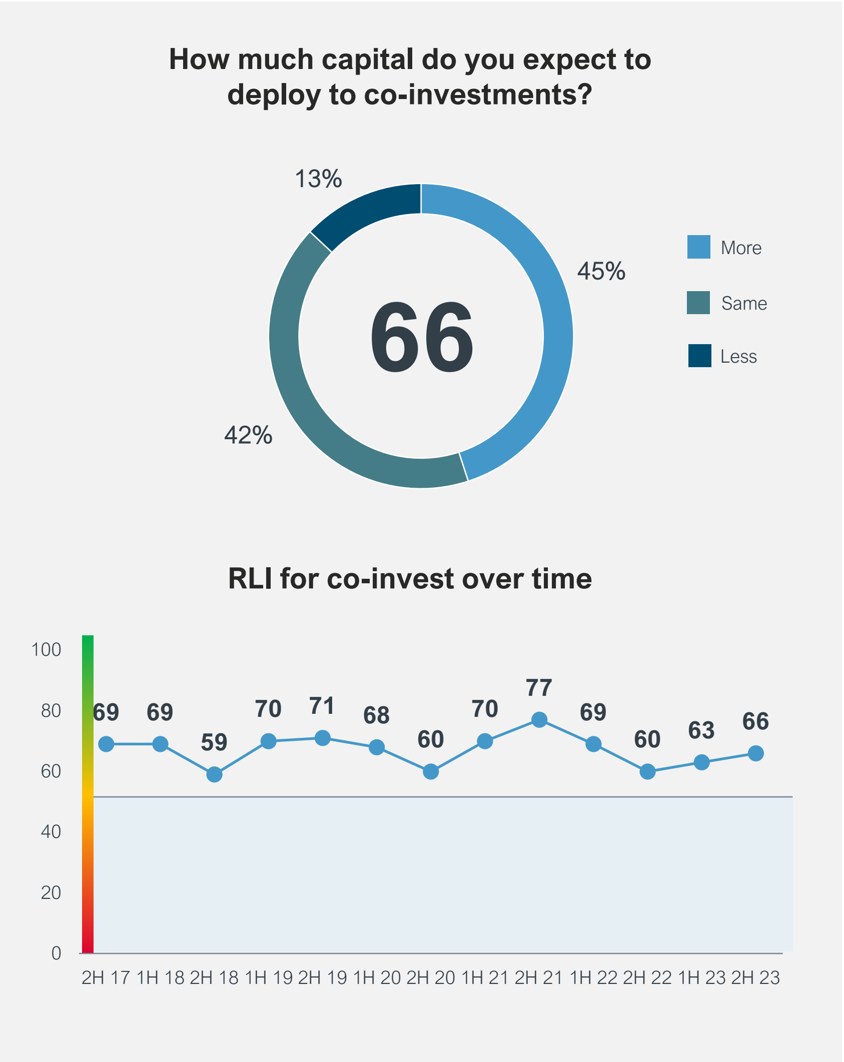
- The RLI scores for certain investor types have risen since 1H 2023: notably, the RLIs for Endowments and Foundations, Pension Funds, and Insurance/ Banks rose by 14, 13, and 4 respectively
- This indicates an increased appetite to deploy to private markets among these LPs in the next 12 months
- In contrast, the RLI for Funds of Sovereign Wealth Funds / Government Agencies and Funds / Consultants fell by 20 and 10 points respectively, while the RLI for family offices remained stable
- In terms of RLI by allocation smaller we see a clear pattern whereby smaller LPs are more liquid than larger ones. LPs with less than €1bn private equity allocation are on average expecting to increase their deployment to new funds over coming months, while those with allocations greater than €10bn are expecting a significant contraction in their deployment



- These large investors obviously have an outsize impact on the fundraising market as a whole – but it should be noted that we are, anecdotally, seeing an increase in the total number of active LPs at the smaller end, which provides some counterbalance to this more pessimistic picture

RLI for coinvestment

- The 2H 2023 RLI for co-investments of 66 highlights continued investor appetite for this type of allocation. The number of investors planning to deploy less capital to co-investments has continued to fall from 15% in 1H 2023 to 13% in 2H 2023, while a considerable 87% plan to deploy the same or more to these investments
- As the tough fundraising market continues, GPs with significant coinvest offerings are seeing real positive impact on their fundraising success



Background and methodology

When Rede Partners launched the RLI in the first half of 2017, the objective was to create an index/numerical value which would reliably show investor sentiment across the PE LP universe for the 12 months ahead and which could be tracked quantitatively over time.

To achieve this, we assembled the 'RLI Panel' – a stable of leading institutional investors from across the globe who consistently respond to the RLI survey every six months.

It is the RLI Panel's quality and consistency that lies behind the robustness of the index. For each edition, we look to maintain the integrity of the panel while selectively adding additional high-quality institutional investors in particular areas. We would like to thank all our RLI panelists and survey participants for their time and insights.

Undertaken twice yearly, the RLI is assessed through six basic questions. LPs are asked to project if their liquidity for the upcoming 12 months will increase, decrease or remain the same compared to the previous 12 months across six sub-indicators – all primary funds deployment; existing relationships deployment; new relationships deployment; co-investments; secondaries deployment (both funds and direct); and distributions.

Methodology

The RLI is based on the same concept as the Purchasing Managers' Index – an indicator of the economic health of the manufacturing sector.

The survey was sent out to a select group of global institutional LPs, chosen to provide geographic and source of capital diversification. The overall RLI has representation from all over the world. In the more detailed analysis, we have only included the categories which had enough respondents to be statistically relevant.

For each question, LPs were asked if they were expecting to deploy MORE (>), the SAME (=) or LESS (<) during the upcoming 12 months compared to the previous 12 months. RLI data is presented in the form of a diffusion index, which is calculated as follows:

RLI = (P1 x1) + (P2 x0.5) + (P3 x0)

Where:

P1 = Percentage number of answers that reported an increase

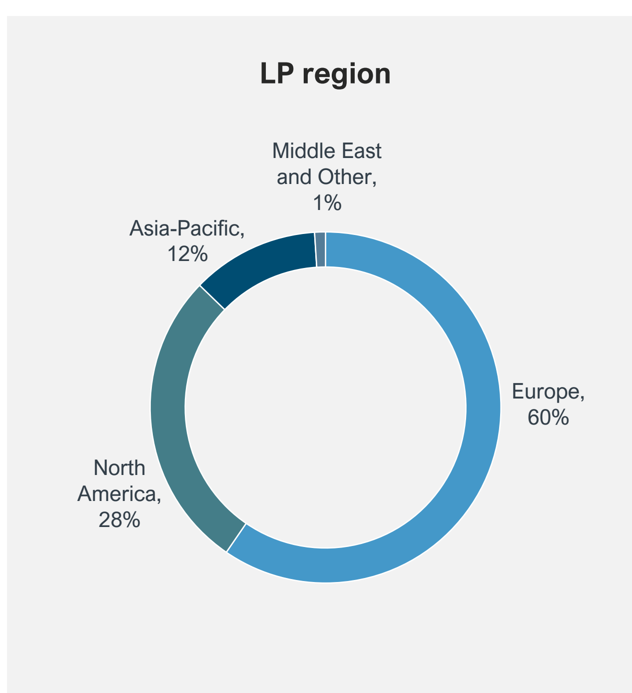
P2 = Percentage number of answers that reported no change

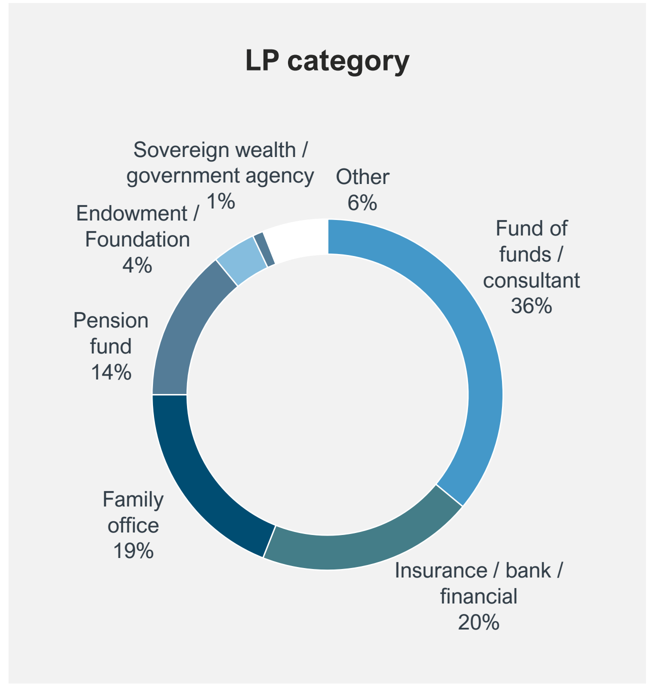
P3 = Percentage number of answers that reported a decrease

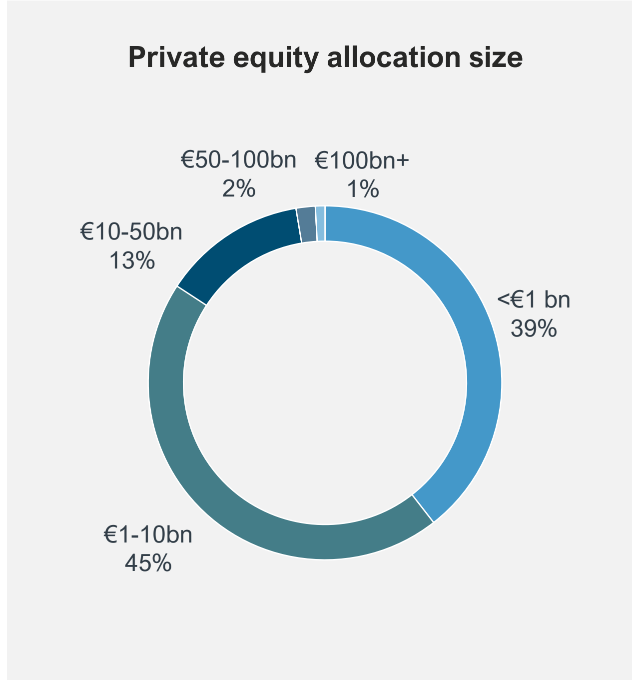
If 100% of the respondents reported an increase, the index would be 100. If 100% reported a decrease, the index would be zero. If 100% of the panel saw no change, the index would be 50. Therefore, an index reading of 50 means that the variable is unchanged, a number over 50 indicates an improvement, while anything below 50 suggests a decline.

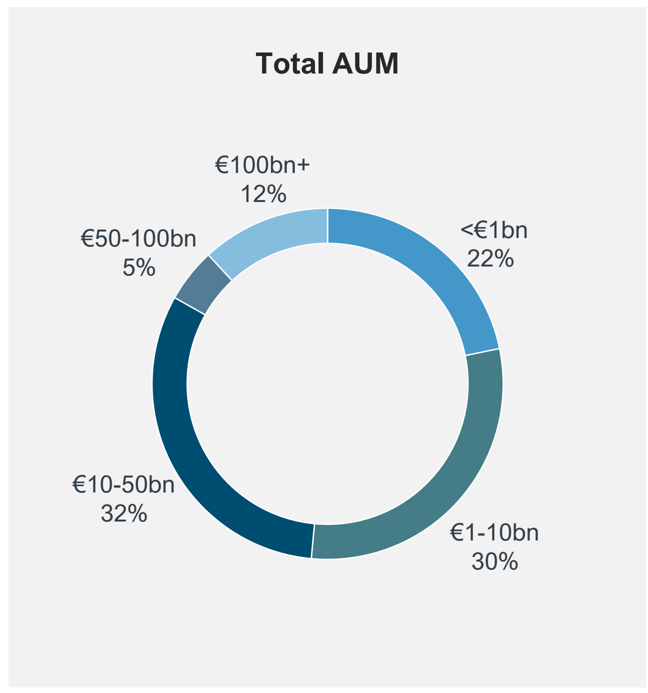
The RLI Panel

We surveyed 120 institutional LPs from across the globe, representing a broad range of investor categories, geographic locations and allocation sizes.









rede /rēd/
Chiefly British dialect, old English

-verb (used with object)
1.to counsel; advise
2.to explain; interpret

-noun
3.counsel; advice
4.a plan
5.a story

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